BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

In the Matter of the Application of San Jose Water Company (U168W) for Authority to Determine Its Cost of Capital and to Apply that Cost of Capital in Rates for the Period From January 1, 2010 through December 31, 2012.	Application 09-05-001 (Filed May 1, 2009)
In the Matter of the Application of Valencia Water Company (U342W) for Authority to Adjust Its Cost of Capital and to Reflect That cost of Capital in Its Rates for the Period from January 1, 2010 through December 31, 2012.	Application 09-05-002 (Filed May 1, 2009)
Joint Application of Park Water Company (U314W) and Apple Valley Ranchos Water Company (U346W) for Authority to Establish Authorized Cost of Capital.	Application 09-05-003 (Filed May 1, 2009)
In the Matter of the Application of San Gabriel Valley Water Company (U337W) for an Authorized Cost of Capital for 2010 through 2012.	Application 09-05-004 (Filed May 1, 2009)
Application of Suburban Water Systems (U339W) For an Authorized Cost of Capital for Utility Operations for 2009.	Application 09-05-005 (Filed May 1, 2009)

COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES TO ADMINISTRATIVE LAW JUDGE LONG'S PROPOSED DECISION

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COMMENTS
OF THE DIVISION OF RATEPAYER ADVOCATES TO ADMINISTRATIVE LAW JUDGE LONG'S PROPOSED DECISION

I. INTRODUCTION

Pursuant to Rules 14.3(a) of the California Public Utilities Commission's ("Commission") Rules of Practice and Procedure ("Rules") and the Ruling of Assistant Chief Administrative Law Judge Michelle Cooke on August 13, 2010**,** the Division of Ratepayer Advocates ("DRA") hereby files its comments to Administrative Law Judge ("ALJ") Douglas Long's Proposed Decision ("PD") in San Jose Water Company ("San Jose"), Valencia Water Company ("Valencia"), Park Water and Apple Valley Ranchos

Water Company ("Park"), San Gabriel Valley Water Company ("San Gabriel"), and Suburban Water Systems' ("Suburban") (hereby referred to as the "Applicants") applications for authority to establish their authorized cost of capital utility operations for 2010-2012.

DRA would like to thank and extend its appreciation to ALJ Long for his patience and work in this proceeding that included many Parties, issues, and documents to manage.

II. THE PD APPROPRIATELY ESTABLISHES THE RETURN ON EQUITY ("ROE") AT 10.2%

The PD establishes the ROE for all the Applicants at 10.2% after considering the evidence regarding the continuing uncertainty of the financial market, creditworthiness, interest rate forecasts, quantitative financial models, additional risk factors, and size and access to financial markets. *See* PD, p.47. It found that size variations, equity ratio, and operational differences between the Applicants cannot be precisely calculated to derive a numeric adjustment to this return. Id.

DRA based its ROE recommendations on various studies it performed that calculated the appropriate ROE, its review of how well water utilities have performed during and since the financial crisis, and whether special firm-specific risk premiums should be added to DRA's 9.75% benchmark ROE. *See* Exhibit DRA-1, Attachment JRW-12; Attachment JRW-3; and Attachment JRW-13.

Given the evidentiary record in this case, the PD appropriately set its proposed 10.2% ROE after considering the various models, interest rate forecasts, creditworthiness, current state of the financial market, various risk factors, and utilities' access to financial markets. The Commission should adopt a 10.2% ROE for all the Applicants.

III. THE PD COMMITS LEGAL ERROR BY ADOPTING THE APPLICANTS' FORECASTED DEBT COSTS WITHOUT ANY REASONED BASIS

The PD addresses long-term debt and preferred stock costs by summarizing DRA's debt cost recommendations, agreeing with DRA's recommendations, and then summarily adopting the Applicants' debt and preferred costs without any basis for why the PD has determined the Applicants' figures should be adopted. *See* Pages 22-24 & Page 25.

The PD states that "…we conclude that the latest available interest rate forecast should be used to determine the forecast of additional debt included in the embedded debt for the forecast period." *See* id. at 22. Thus, the PD concludes that only the "latest available" debt rates should be utilized in forecasting additional debt.

It then begins its summary of DRA's proposed cost of debt by describing how DRA used the Applicants' proposed 2010 debt cost rates and how DRA argued that "forecasts of future interest rates are not accurate, and therefore the projected debt cost rates beyond 2010 are not useful." The PD also concludes how it would be improper to rely on the utilities' proposed debt cost beyond 2010. Id. at 23.

The PD also cites how DRA explained that San Gabriel did not have any bids during its testimony or pricing quotes for its anticipated debt issues, how it historically used a 246 basis point spread to forecast its long-term debt rates for anticipated issues, and how San Gabriel imputed 492 basis points in forecasting its mortgage bond interest rates it plans to issue in 2010 and 2012. Id.

The PD further addresses how DRA argued that the spread for Utility BBB rated bonds peaked at 450 basis points in December 2008 and was at 250 basis points as of July 2009 and how the financial markets have stabilized since the peak of the crisis and spreads are continuing to move downward towards historical trends. Id.

The PD adds that: 1) DRA's review of the 2010 through 2012 forecasted spreads between Baa Corporate Bonds and 30-Year Treasury Bonds is based on the May 2009 Global Insight Forecast; 2) the average spread over the three year period (2010-2012) is 334 basis points based on the most recent Global Insight forecast; and 3) the most recent Federal Reserve data shows that as of June 2009, the spread between Baa Corporate Bonds and 30-Year Treasury Bonds reached 300 basis points, which represents a 256 basis point drop since its peak of 556 basis points reached in December 2008. DRA stated that this spread has continued to drop and as of August 2009, the spread between the Baa and 30-Year Treasury Bond yields was 221 basis points. *See* PD, p.23-24.

DRA requested the Commission take public notice of this information for the record, and the PD grants this request. Id. at 24.

The PD continues its description of DRA's perspective on debts costs by including DRA's discussion regarding how other utilities have recently issued secured debt issues with spreads significantly lower than San Gabriel's proposed 492 basis points. In June 2009, Valencia issued $12 million in 30 year Senior Secured Notes at a rate of 7.73%, a spread of 321 basis points based on the historical June 2009, 30-Year Treasury Bond yield of 4.5%. DRA also stated how Park issued two new first mortgage bonds in June 2008 with spreads of 285 and 300 basis points. Id.

The PD also describes how DRA concluded that if San Gabriel's spread is just slightly higher than its historical 246 basis points, recalculating the company's weighted debt cost results in an average debt cost of 7.55% over the three year period compared to San Gabriel's 7.81% and how DRA continued to assert that the weighted average debt cost for the utilities should be based on 2010 projections rather than relying on forecasts beyond this period, which would be inaccurate and would change substantially. Id.

And lastly, under Section 8.2 Discussion, which follows the PD's descriptions of DRA's debt cost recommendations, the PD states "We agree with DRA that the utilities' projected interest rate spreads beyond 2010 are very high and rely on the early impacts of the financial market crisis." Inconsistently, however, in the very next section of the PD, entitled "8.3 Actual and Imputed Capital Structures," under the 2nd paragraph, 2nd sentence, the PD states summarily that "We find the Applicants' forecasts of debt and preferred costs for 2010 to be reasonable." This statement seems to adopt the Applicants' debt cost forecasts, but it appears in a surprising spot in the PD and also is not backed up with any reasoning or foundation.

As illustrated earlier, the PD previously summarized in much detail DRA's recommendations and then appeared to adopt DRA's position under the "Discussion" Section that followed right after DRA's summary of its position. The PD in the

"Findings of Fact, # 13" however states "The Applicants' 2010 forecast of the cost of new debt is the most reasonable evidence." See PD, p.67.

Thus, the PD commits legal error by adopting the Applicants' debt and preferred costs without providing any reasoning or basis for this determination. The Commission should adopt DRA's well-reasoned debt cost recommendations that the PD describes in so much detail and largely agrees with.

DRA suggests the following Finding of Fact to replace what is currently included under # 13: "DRA's 2010 forecast of the cost of new debt is the most reasonable."

IV. THE PD COMMITS LEGAL ERROR BY ADOPTING THE APPLICANTS' PROPOSED CAPITAL STRUCTURES

The PD states it will not "impute a different capital structure at this time and will not impute DRA's proxy structure." *See* PD, p.25. It is legal error for the PD to not impute different capital structures when it acknowledges that it is concerned about Valencia and San Gabriel's substantially high equity ratios and how this harms ratepayers who have to pay higher costs for higher equity ratios.

The PD instead only orders Valencia to justify in more detail its capital structure during its next cost of capital proceeding. It makes this suggestion to both San Gabriel and Valencia in the text of the PD, but only includes an ordering paragraph on this issue for Valencia. *See* id. at p.71.

While the PD allows the Applicants to proceed with their current capital structures, DRA's testimony developed capital structures for the water companies that reflect both the individual company capitalizations as well as those of the proxy group of publicly-held water companies. This is necessary since the capitalizations of the water companies have higher common equity ratios than the companies in the proxy group, which are used to determine the equity cost rate of 9.75%. *See* DRA Opening Brief, p.45.

Thus, it is appropriate to apply a capital structure where the utility's proposed capital structure exceeds the proxy group average. DRA's approach of averaging the water utilities' 3-year estimate with the Water Proxy average, provides a fair balance in determining the cost of capital. Id. at 46.

The PD noted its concern over Valencia (74.65%) and San Gabriel's (62.10%) significantly higher equity ratios that exceed the Water Proxy group average equity ratio of approximately 50%. With the PD's text expressing concerns over these equity ratios, it is legal error to still adopt the Applicants' capital structures. "We are concerned however that Valencia has a very high equity ratio over 70% and San Gabriel comes in over 60%. These high equity ratios significantly drive total cost to ratepayers higher because of both the higher return applied to equity over debt and the required allowance for income taxes." See PD, p. 25.

Just as the PD adopts the Applicants' debt and preferred costs instead of DRA's, despite describing and discussing in much detail DRA's argument on the capital structures too, the PD still summarily adopts the Applicants' capital structures without any cited basis or foundation from this proceeding's record to show why the Applicants' proposed capital structures are more reasonable.

The Commission should adopt the imputed capital structures DRA has recommended. Giving these utilities another "pass" in bringing their equity capital ratios more in-line with the proxy-group results in ratepayers continuing to pay a higher rate of return than is reasonable. For example, in Valencia's last GRC in 2007, the Commission adopted a common equity ratio of 69%.[1] Three years later the PD here is now proposing nearly a 75% common equity ratio. This shows that Valencia has not taken any steps to reduce its equity ratio and instead has increased it since its last rate case. There are no mechanisms to encourage utilities to reduce their high equity ratios unless the Commission adopts imputed capital structures.

[1] D.07-06-024, mimeo, p. 20.

V. THE PD COMMITS LEGAL ERROR BY DOUBLING THE LOWER BOUNDARY OF THE WATER COST OF CAPITAL ADJUSTMENT MECHANISM ("WCCAM") WITHOUT SUPPORT FROM THIS PROCEEDING'S RECORD

The PD adopts the same cost of capital adjustment mechanism adopted in Decision ("D.")09-07-051, but modifies it by increasing "the lower boundary of the dead band to 200 basis points to reduce the potential for a large downward adjustment to the authorized return on equity caused by the economic recovery which may significantly change the Moody's bond indices." *See* PD, p.61.

This diversion from the Settlement in D. 09-07-051 is not based on the record in this proceeding. The figure of 200 basis points was not addressed or discussed in this proceeding and no party ever proposed it to represent the lower boundary of the dead band for the trigger mechanism. The Commission cannot adopt this figure without some support from the record. To do so otherwise would be legal error.

Additionally, setting this trigger at 200 basis points is unfair to ratepayers since it makes the lower band 200, but leaves the upper band at 100 basis points. This essentially shifts the risk to ratepayers because the Applicants will continue to receive a windfall of lower capital costs by significantly decreasing the probability that the mechanism will trigger an adjustment to lower the authorized ROE within the next three years. Leaving the upper band at 100 basis points does not change the risk to shareholders by shifting to the symmetrical mechanism that is currently adopted for the larger Class As and the energy utilities.

The Commission should adopt the exact triggers included in the Settlement in D. 09-07-05.

VI. CONCLUSION

The PD appropriately sets the ROE at 10.2%, but commits legal error by adopting the Applicants' debt costs and capital structures.

Respectfully submitted,

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September 17, 2010

CERTIFICATE OF SERVICE

I hereby certify that I have this day served a copy of the foregoing document **"COMMENTS OF THE DIVISION OF RATEPAYER ADVOCATES TO ADMINISTRATIVE LAW JUDGE LONG'S PROPOSED DECISION"** in proceedings **A.09-05-001, A.09-05-002, A.09-05-003, A.09-05-004 and A.09-05-005.**

A copy was served as follows:

[**X**] **E-Mail Service:** sending the entire document as an attachment to an e-mail message to all known parties of record to this proceeding who provided electronic mail addresses.

[ ] **U.S. Mail Service:** mailing by first-class mail with postage prepaid to all known parties of record who did not provide electronic mail addresses.

Executed in San Francisco, California, on the 17th day of September, 2010.

/s/ REBECCA ROJO

Rebecca Rojo

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